THE MARKETING OF AMERICAN RAILROAD SECURITIES

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Memorandum in explanation of the various methods of marketing securities and the experience and considerations upon which is founded the existing custom of the principal American railroad companies of marketing their securities through bankers, and more particularly the practice of numerous railroad companies in dealing with some particular banker or banking group.

A CONDITION of controlling force in every public service industry and having particularly important consequences in connection with American railways, is the persistent necessity for extensions and improvements that constantly require the investment of additional capital.

Some measure of the extent of this continuing absorption of capital is supplied by the records of the Interstate Commerce Commission, which show that between July 1, 1907, and the same date in 1912, the railways reporting to the Commission found it necessary to add the immense sum of $2,823,220,561 in cash to the actual cost of their facilities.

It has been estimated by several high authorities that in order to meet with any degree of adequacy the requirements

*[This memorandum was written shortly before the outbreak of the European war. The then anticipated occasion for publishing it did not arise. It is now published exactly as it was written at that time. The financial developments brought about by that war only emphasize the value and importance of the services which bankers are qualified to render. The economic changes resulting from the war do not call for any modification of this memorandum except only in respect to what is stated therein as to the placing of American railroad issues in Europe, inasmuch as such transactions will be impracticable for the time being and doubtless for some years to come.—OTTO H. KAHN.]

of the situation for new construction, for additional main tracks, sidings and yards, for equipment and terminal facilities, for elimination of grade crossings, especially in the larger cities, for block signaling and other safety appliances, and the requisite general strengthening and improvement of existing properties, expenditures are called for, aggregating from $700,000,000 to $1,000,000,000 each year for a series of years to come.

In other words, there is a never-ceasing demand in the United States for more and better railway services, and unless this demand is to remain unsatisfied the railway managements must find some way to attract to the railway industry an uninterrupted and steadily augmenting flow of new capital.

The sole means available to obtain from investors the additional capital necessary to meet this constant pressure for extensions and improvements is the sale of shares of stock, mortgage bonds or other securities. In addition, a large volume of securities must be distributed annually in order to refund maturing obligations. For this reason, the determination of the best method of disposing of the securities required to obtain new capital constitutes a problem which every railway management must do its best to solve.

The prime necessities of a satisfactory method are—

(1) that the capital requirements of a program covering a considerable period and requiring a considerable total outlay may be provided for in advance and with certainty, and

(2) that the price obtained for railroad securities shall be as high as the circumstances warrant.

It is obvious that neither of these conditions can be met by any method that does not commend the investment as strongly as the facts justify to the largest possible number of potential investors.

Three methods of marketing railway securities may be considered. These are:

A. Public offerings, calling for bids.
B. Offerings to shareholders at a fixed price.
C. By negotiation with investment bankers.

These methods will be examined and their relative advantages and disadvantages (if any), as may appear, discussed.

I

The Existing Practice

As a rule, railroad companies of the United States, like those of other countries, market their securities by selling them either to or through bankers. Even in cases where securities are offered for *pro rata* subscription to a corporation's stockholders is it customary for the corporation to protect itself by arranging with bankers to underwrite, or to form a group to underwrite, their sale, that is, to agree to purchase such of the securities as are not taken by the stockholders.

The cases in which railroad companies have successfully sold their securities direct to the investor are exceedingly rare.

Most of the important railroad companies make a practice of dealing with a particular banking house or a particular group of bankers in marketing securities. This relationship rarely rests on formal contract. The cases in which a railroad company formally appoints a banking firm its fiscal agent or banker are few. As a rule, the relationship is informal and tacit.

A railroad company gradually comes to recognize a particular banking house* as its banker so that in case it has securities to be sold or underwritten it naturally looks to that banking house to take charge of the business, especially in large issues of securities.

*The term "Banker" or "Banking Firm," as used in this article, is meant to include any financial concern, private or corporate, engaged in the business of purchasing and issuing securities.

From the nature of the case, there rarely can be a standing agreement or understanding as to the prices and terms upon which a banker will purchase or underwrite securities for a railroad company whose business he regularly handles. Usually the prices at which securities can be sold or underwritten depend too much upon time and circumstances to render any such undestanding practicable.

Therefore, the relationship between a railroad company and its banker is of the most indefinite character. The existence of such a relationship means not only that when the railroad has securities to be sold or underwritten, it first goes to its banker and endeavors to negotiate an arrangement, but it means that the railroad has at its disposal continuously the services, skill, standing, experience, advice and financial potency of the banker.

The banker's functions are, for instance, to keep track of the financial situation and requirements of the railroad, to assist in the preparation,—in advance of the need—of a proper and serviceable system for financing such requirements, to advise as to the class, kind and denomination of securities to be issued and as to the best time for selling them, so that his clients may not miss an opportune moment for meeting their requirements, to scrutinize the mortgages and deeds of trust under which securities are to be issued, and to indicate from his survey of the markets of the world his judgment as to the amount of securities which could be absorbed in one or the other market.

The terms of a negotiation are by no means imposed by the banker, for it is easily within the means, and is as an important and responsible duty, of those conducting the negotiations on behalf of the railroad company, to acquaint themselves with the reasonable market value of the securities which it desires to sell and to insist upon obtaining a fully adequate price.

The terms are the subject of negotiation and agreement, and if a railroad company cannot secure what it considers

satisfactory terms from the banker it either postpones the business or takes it to other bankers.

Competition, the prevailing market prices of existing issues, fix very closely the prices at which new securities can be sold to investors, and competition and custom likewise regulate the profits and commissions of bankers. The banker who would make a practice of marketing the securities of his clients at prices materially below the prevailing prices, would soon lose his clients.

All of this is equally true of the relations between a railroad company and a banker who happens to sit upon its board of directors. The influence which the directorship gives to a banker in dealing with the corporation of which he is a director, has been very greatly exaggerated and the conditions under which a banker deals with such a corporation have been much misunderstood and misinterpreted.

In the matter of the prices at which securities are acquired, it is by no means an aid or advantage to a banker to be on the board of a railroad, and it is easily susceptible of proof that railroads dealing with bankers who sit on their boards, obtain certainly as favorable prices for their securities as railroads of similar credit and standing not having bankers on their directorate.

Bankers advise on the methods, times, etc., for the issue of securities, but do not themselves determine or control the prices at which they buy a company's securities. Nor do banking interests dominate the Boards of Directors of railroads nowadays, as they undoubtedly did, to a considerable extent, in former days.

The instances are comparatively infrequent where a railroad company, after having once established relations with a strong banking house which has effectually handled its securities and gained its confidence, finds it to its interest to change that relationship—a relationship which, whilst not limiting the railroad's freedom of action according to its own judgment of its best interest, does involve upon the part

of the bankers certain definite and continuous duties and obligations, more fully referred to later on.

It is manifest, on the other hand, that a railroad company usually is, and always ought to be, free to terminate its relationship with its bankers.

That changes in the relationships between railroads and bankers do occur quite frequently is indicated by the variations which take place in the course of time, in the connections, and the relative influence and position of the prominent banking firms which deal in railroad securities.

It is now claimed in certain quarters that the practice above outlined is wrong and that railroad companies would do better if they would discontinue the practice of dealing regularly with particular banking houses, and, whenever they have securities to sell, would offer them for competitive sale, regardless of past affiliations.

Some even urge that bankers should not be used at all, not even upon a competitive basis, but that the railroad companies should sell their securities directly to their own stockholders or to investors, preferably offering them for public competition and accepting the bids of the highest bidders.

II

The services of the bankers in the sales of large issues of securities are, with rare exceptions, essential to assure success.

In selling all kinds of commodities a certain degree of skill, efficiency and experience is required. Some commodities are more easily sold than others. Most commodities can be sold, in limited quantity and at distinct concessions in price, at public offering or auction.

But it is recognized that the public reached by any such offering is never more extensive than the extent of the interest which through advertising and otherwise it is possible to arouse, and of the general knowledge of the character

and quality of the commodity offered, and that to at least the extent in which bidders are uncertain as to quality their bids are below actual value. Railway securities are commodities having widely varying values both as to different securities at the same time and as to the same securities at different times. They are offered to purchasers who are asked to exchange for them portions of their capital possessions, and the timidity of investors is a well-known and important element in the problem of distribution.

Hence, whatever corporation offers its securities at public auction cannot expect to receive bids from investors who are outside of the relatively limited field in which the corporation and its management and the intrinsic merits of the particular securities offered are known.

In the case of railways in the whole region west of the Mississippi river no local market of adequate proportions can be counted on, for, as is well known, the people of this region find other local investments so much more profitable and satisfactory that they are generally averse to investing in railway securities to any large extent.

Those who advocate that railroad companies should make a practice of selling their securities directly to their stockholders, or to investors without the intervention of bankers, ignore the conditions under which modern business on a large scale must be done. It is safe to say that there is no business which requires in greater degree the combination of skill, experience, capital and reputation than is required in the sale of securities on a large scale.

A railroad company cannot be expected to possess that combination. The sale of securities is not its business. It is simply incident to its business, or rather a means of placing it in a position to carry on its business. Accordingly, when it has securities to sell, it naturally turns to those who are skilled, efficient and trustworthy in the sale of securities.

Railroads would suffer seriously in credit from unsuccessful efforts to sell securities by public subscription.

If railroads offered bonds direct for public subscription in limited amounts, the result might be fairly satisfactory in good or normal times, although even then, deprived of the facilities, the skill and the sponsorship of responsible bankers, the prices obtained would probably be lower than those which would have been realized by dealing with a banker, to say nothing of the uncertainty in which the railroad would necessarily find itself as to what portion of the funds it requires would be realized as the result of the public offering.*

In unfavorable times, of course, the public's response would be small, at times exceedingly small. It occurs very frequently that bankers or syndicates have to carry issues of bonds which they have purchased for many months or even years, until investment demand returns. If an issue of bonds offered by a railroad for competitive bids on direct public subscription resulted in non-success, the issue, if then saleable at all, could only be disposed of at a very heavy sacrifice.

The non-success of such public offering and the consequent public knowledge that the railroad has been unable to obtain the funds it requires, would always cause grave damage to a railroad's credit, if it did not for the time entirely destroy it, would cause alarm amongst investors, and in not a few cases might cause bankruptcy.

Even in the case of great cities like New York whose securities command the highest degree of public confidence and who are compelled by law to make public offering of their securities and to sell them to the highest bidders, the highest bidders are usually banks and bankers, who buy the securities in the first instance for ultimate sale to investors.*

Investors as a class prefer to buy even municipal se-

*A few weeks ago the Vermont Valley Railroad offered for competition by sealed tenders an issue of $2,300,000 of its 6% one year notes. Although the Vermont Valley Railroad is a very prosperous concern, having paid dividends at the rate of 10% per annum for nine years, and the notes have the additional security of being guaranteed by the Connecticut River R. R. Co., the offering resulted in complete failure, practically no bids having been received.

*Even so exceptional a security as the Bonds of the State of New York which were offered for public competition several years ago, were not subscribed for by the public at prices equalling those bid by Bankers, and both issues in their entirety were consequently allotted to Bankers.

curities from bankers rather than directly from cities, because they want the benefit of the advice and judgment which the trained banker is competent to give, and of the moral responsibility which goes with them.

It is a matter not of surmise but of recorded fact that, many times, owing to the insufficiency of subscriptions on the part of the general public, offerings of bonds by the City of New York would have failed and the City would have been subjected thereby to serious embarrassment if it had not been for the subscriptions by banks and bankers.

There is no reason to believe that the cities have been better off under the practice of selling bonds at public offering to the highest bidders than they would have been had they been permitted to deal privately with the bankers as do the railroads. But, even if it were otherwise, it is manifest that railroad companies could not possibly expect to fare as well as do the municipalities if they had to depend upon the uncertain and fluctuating public demand by attempting to sell their securities at public offering to the highest bidder.

Especially does this hold true in the case of the less strong railroads, for the investing public at large will neither go to the trouble, nor possess the qualifications, to analyze for itself the position of, and to form a reasoned estimate based upon the compilation and study of statistical and other data as to the degree of safety of, the securities of the less well-known properties.

Such analysis and study is one of the functions of the Investment Banker who in buying the securities and offering them for sale gives public notice, so to speak, that he has examined into, and satisfied himself as to, their intrinsic safety and merit, who places the information gathered by him at the disposal of his clients in convenient and easily understood form, and who in proportion to the weight of his reputation and his moral responsibility enhances the salability and the standing of the securities for which he becomes sponsor.

III

The relationship which ordinarily exists between a railroad company and its bankers is advantageous to the railroad company.

The considerations which make a system under which railroads would offer their securities direct to the public precarious and dangerous, are so commonly recognized and understood that it may safely be assumed that no well informed person will seriously contend that it would be either safe or advantageous for railroad companies to pursue the practice of marketing their securities without the aid of bankers.

The criticism therefore which remains to be seriously considered in a discussion of this subject is of the practice by which a railroad company regularly deals with a particular banker and gives that banker the preference when it has securities to be sold or underwritten. The following considerations are offered in support of that practice:

1. *A railroad must be certain of its ability to secure the necessary funds for its commitments.*

It is of the greatest importance for a railroad, when making commitments for expenditures for improvements, new construction, equipment, etc., to be certain that it will be able to sell the requisite securities when such commitments come due and must be met.

In dealing regularly with a banking house of ample financial strength and wide connections in America and Europe, the railroad company is assured that it will be able to obtain the requisite funds, even in unfavorable times, because the banking house, in order to insure the continuity of the connection and the solvency of the railroad, cannot do otherwise than use to the utmost the resources and the facil-

ities of connections and credits at its disposal, to provide for the requirements of the railroad.

If, on the other hand, the railroad had been in the habit of selling its securities on a promiscuously competitive basis, it would have no such friend in need, and the various bond and banking houses would naturally buy its securities only as it suited their own purposes. The strongest railroads have found themselves in the situation where large sums of money were imperatively needed in most unfavorable times and where only their old established claims upon their regular bankers enabled them to obtain the necessary funds.

It has of late years been a matter of not infrequent occurrence that during the pendency of applications for the approval by a public service commission of proposed bond issues, railroads have found themselves in need of temporary financial accommodation. Such accommodation, if so desired by the railroad or if not readily or opportunely obtainable from the railroad's Bank connections, is furnished by the railroad's banker.

Furthermore, in the case of bonds, the application for the issue of which is pending before a public service commission, it is not unusual for the banker, at the railroad's request, to obligate himself to purchase such bonds, subject to the approval of their issue by such commission, so that the railroad is protected against an unfavorable change in the investment markets while its application is being considered and is certain of obtaining the needed funds as soon as the application is granted.

The temporary financial accommodation above referred to, and the definite sale of bonds in advance of, and subject to action by public service commissions, have at times been of great service and value to railroads. Neither expedient would be at the service of a railroad if securities were sold by competitive bidding among various banking houses.

Several of our railroads find themselves at this time on the brink of financial difficulties and have applied to Bank-

ers to evolve plans and inaugurate measures for their financial rehabilitation without the expense and detriment of a receivership, and for the strengthening of their impaired credit. The accomplishment of this task on the part of the Banker involves much thought and study as well as financial risk and the assumption of great moral responsibility toward investors who following the Banker's advice may aid in furnishing the requisite funds and who mainly look to the Banker to safeguard such investments.

No Banker could reasonably be expected to undertake this task and assume that responsibility if he had to expect that after having devoted his time, effort and reputation to the work, the security-issues of the railroad would thereafter be thrown open to competitive bidding, regardless of whether or not his own services were faithful and efficient and satisfactory to the Board of Directors and the Management.

2. *Value of the banker's expert advice.*

In dealing regularly with one banking house, a railroad obtains the benefit of expert advice as to financial policy, as to the best and most opportune time for selling securities and for providing for its financial requirements, as to the class and kind of securities to be issued, and as to the best method of offering them to the public here and abroad.

The element of the selection of time is of much importance in itself, for it happens not infrequently that the lapse of a single week measures the difference between reasonably favorable and unfavorable or even totally forbidding conditions.

The ebb and flow of the currents in the investment markets depend on many and complex conditions and considerations, and it is one of the functions of the competent banker to keep himself posted as to affairs, aspects and prospects in America, Europe and elsewhere, and to anticipate in his

judgment and advice their results and their effects upon the money and investment markets.

The mortgages and trust deeds under which the securities are to be issued, before being put in final shape, are carefully gone over by the banker, and his advice is given with the view to creating the best and most saleable instrument satisfactory both to the public and to the railroad company. Such advice is frequently, especially in the case of large refunding mortgages which are meant to be the principal means of raising money for the railroads for years to come, of very great utility.

Investors attach considerable importance to knowing that the mortgages, trust deeds, etc., and all legal steps relating to the issue of securities which they are asked to buy have been carefully examined by counsel for bankers of repute and experience, with a view to safeguarding the interest of the holders of the bonds as distinguished from those only of the railroads, the makers of the bonds.

3. *The value of a banker's reputation for care in the scrutiny of securities and in safeguarding the interests of investors.*

The leading bankers could not maintain their position as such, if they did not have pre-eminently the confidence of the investing public and a large following amongst investors, large and small, both here and abroad. Their reputation for carefulness in connecting their name with a security, thereby assuming the moral responsibility for its soundness, and for examining closely and efficiently the character of the security and of the provisions of the mortgage or trust deed, constitute a distinct additional investment value to the issues for which they become public sponsors.

In this connection. it is the banker's duty and to his own self-interest to protect and stand behind the securities which he has sold to the public, just as it is his duty and to his own

self-interest to satisfy himself by careful investigation as to the soundness of such securities, because the banker whose clients suffer loss through following his advice will very soon lose his reputation and the confidence and patronage of his clients. He knows well that such reputation and confidence are the mainstays of the prosperity and success of his own business and, once forfeited, are exceedingly difficult to regain.

It may safely be said, generally speaking, that such railroad issues as are known to be under the habitual sponsorship of well-known and strong bankers have a wider and steadier market and command better prices amongst investors than those which are not under such auspices and responsibility. Reference is here made to the observations on a preceding page (under 2) as to the particular and essential need of some well-known and trusted banker's sponsorship for the securities of the less strong and well-known railroads, in order to induce investors to purchase said securities.

If the sale of securities were thrown open to competitive bidding, the possession of large capital would become the prime, if not the sole, requisite for dealing in securities, and the financier or combination of financiers controlling the largest amount of capital would have a vastly more potent advantage over others than under now existing conditions. The exercise of care, skill, industry, scrutiny and the sense of moral responsibility toward clients which now are and always have been the prerequisite for acquiring the reputation and the public confidence upon which an Investment Banker's position depends and without which it cannot be maintained for any length of time, would no longer be essential.

4. *Various factors combine to insure fair prices in the sale of securities by railroad companies. There is widespread misapprehension as to the profits made by bankers*

and syndicates upon the underwriting and purchase of securities of railroad companies.

There is a widespread misconception to the effect that the railroads are in the habit of paying a commission to the banker when selling securities to him. When the banker forms a syndicate to underwrite an offer of securities to shareholders a fixed commission is naturally stipulated, such commission being commensurate with the advantage secured by the railroad company in obtaining through the underwriting the certainty of the success of its offering, and with the risk incurred by the banker and the syndicate affiliated with him.

On the other hand, in the case of the sale of railroad securities to or through bankers without an offering to stockholders, it is comparatively unusual for the sale to be on a commission basis. As a rule, the procedure is that the banker makes a firm bid to the railroad for such securities at a fixed price, said price being the figure at which he expects to be able to form a syndicate.

In determining his bid, the banker naturally figures upon a reasonable margin of profit to the syndicate between the price at which it takes the securities and the price at which he estimates that it will be able to place the securities with the public. For his preparatory work, his responsibility and risk and his services in managing the syndicate, the banker makes a charge to *the syndicate,* usually varying from ½ per cent. to 1 per cent.

The banker's financial risk is by no means ended with the formation of the syndicate, as, in practically all cases, he is himself a large participant in the syndicate—is, in fact, expected to be. His moral risk and responsibility towards the syndicate is great, inasmuch as he is relied upon by its members to have examined carefully into the soundness of the security, to have scrutinized the mortgage, to have taken competent legal advice, to have correctly gauged the moment and estimated the price at which the securities can be

advantageously placed with the public, to do the principal work in marketing them, and to guide the work done by others.

If the banker is found wanting in any of these respects, or his judgment proves to be faulty, he loses the confidence of those who habitually participate in syndicates, and with it, his capacity to engage in financial transactions on a large scale, as it is only with the co-operation, financial or otherwise, of syndicates that large transactions can be carried through.

Just as there is a misconception as to the profits of bankers, so a misconception prevails as to the profits of the syndicates formed for the purchase or underwriting of the securities of railroad companies. While in the case of underwriting the syndicate receives a fixed commission, yet, even in such cases, the transaction becomes a purchase to the extent that the syndicate is required to take the securities in the case of the partial or total failure of the offering to stockholders.

In the case of the purchase of securities outright, while, naturally, the syndicate is formed with the expectation of securing a reasonable profit in compensation for its risk and services, actually the profit or loss to the syndicate depends upon the success in marketing the securities. It is, therefore, impossible to state in definite terms the profits of syndicates, but it may be said generally, taking the experience of the last ten years as a basis, that year in and year out those who regularly participate in the syndicates formed by the leading bankers for the underwriting or purchase of the securities of railroad companies do not realize, in the net average result, more than a fair rate of interest upon the capital employed. There are, of course, cases where a substantial profit is made, but there are other cases where losses are sustained. The average is as above indicated, which is easily susceptible of proof.

The normal margin of profit on which the American banker and syndicate figure in purchasing the securities of

railroads is approximately the same as prevails amongst bankers and syndicates in London, when dealing with the securities of corporations or of governments of good standing and credit (apart from those of a limited number of governments, whose power, credit and standing place them in a class by themselves) and is considerably lower than prevails in Paris.

It is also worth mentioning that the London banker does not render the same measure of service to the corporations whose securities he sells to the public as the American banker. It is the practice of the London banker, immediately after the public issue has taken place, to dissolve his syndicate, distribute amongst the syndicate participants any bonds remaining unsold and leave it to them to sell at the best price they can get.

The practice of the American banker, on the contrary, in cases where a public issue has not resulted in placing with the public the entire amount offered, is to keep his syndicate together (sometimes for two years and even longer), to retain charge of the disposal of the unsold balance and to continue his efforts to place the same with the investing public at the original issue price—a practice fairer and more serviceable both to the railroads and to the public.

It might be pointed out in this connection that *notwithstanding the practice of many railroads of dealing habitually with particular bankers, the element of competition is not absent,* because the price and the margin of profit or commission at which a banker concludes a negotiation with a railroad company for its securities is necessarily in competition with the terms upon which other bankers negotiate with other railroad companies for their securities.

In addition, there is the potential competition and safeguard arising from the fact that the railroads in most cases are, and always ought to be, entirely free to deal with other bankers if they deem the terms offered them by their regular banker inadequate, or the resulting profit to him excessive, or if there is any other reason which makes it appear to the

railroad company that its interests would be best served by having recourse to another than its regular banking affiliation.

The prices at which railroads sell their securities are now generally matters of public record. No banker expecting to maintain his regular connection with a railroad company can do otherwise than pay fair value for the securities which it has to sell. It is a matter of self-interest for him to do so.

A banker who would secure from a railroad company its securities at lower prices than are paid by other bankers to other railroad companies under similar conditions for securities of similar class and character, would very soon lose both the trust and the custom of the railroads. In various ways, indications do not fail to reach railroad companies which enable them to place a fair estimate upon the market value of securities which they have for sale, and no Board of Directors could afford to incur the opprobrium and responsibility of selling securities to their regular banking connections otherwise than on the basis of what they are reasonably and fairly worth, considering the time and the conditions.

As a matter of fact, even in the case of those railroads the management and policies of which have recently been the object of investigation and criticism, the charge of not having secured adequate prices for such of their securities as were sold to Bankers has been heard but little if at all.

5. *The advantage of access to foreign markets for securities.*

Not infrequently, a situation arises which makes it of vital importance to a railroad and of great benefit to the financial position of the country to have the European markets opened for the placing of important issues of bonds, without having recourse, or more than a limited recourse, to the American market.

Transactions of this nature are simply impossible of accomplishment unless entrusted to a particular American banking house, because, owing to the manifold and complex requirements for listing and other formalities in the different European countries (particularly in France), and of the business methods, habits and ideas prevailing there, they require weeks of negotiations, the furnishing of a mass of data and explanations, access to particular and potent European connections and much special skill and experience.

The placing of large issues of American securities in Europe—which, as above stated, can only be accomplished through lengthy and complex private negotiations—*would be made impossible through competitive bidding.*

6. *The system in vogue in this country also prevails in Europe, even in the case of most government loans.*

In not a single European country does the system of the competitive sale of securities on the part of corporations prevail. Moreover, most of the Governments, in placing their loans, have recourse to regularly established and continuous connections with a banking house or a group of banking houses.*

7. *The necessity of the underwriting by bankers of issues of securities offered for pro rata subscriptions to stockholders.*

Experience has shown that a very large proportion of the stockholders to whom subscription rights are offered, sell them in the market with the result that the value of the security under offer declines. This very decline has a cumulative effect in causing other stockholders to sell and is fur-

*Not one of the foreign Governments, belligerent or neutral, who since the beginning of the European war have found access to the American investment market for the securities of their respective countries has had recourse to competitive bidding amongst Bankers or otherwise. In each instance the Government concerned has dealt with some one particular Banker or Group of Bankers whom it selected as efficient and worthy of confidence.

ther frequently intensified by short selling on the part of speculators.

All of these influences combine to bring about the possibility of the security under offer declining below the subscription price, which means the failure of the offering. Moreover, not to mention the damage to its credit in case of the failure of such an offering, pending the time during which the securities are under offer to the stockholders—usually not less than from 45 to 60 days—the railroad is uncertain whether or not, or to what extent, the stockholders will subscribe and is, consequently, in doubt whether, at the end of the subscription period, it will come into possession of the funds it requires.

All of this is obviated by the formation of an underwriting syndicate which itself guarantees to take and pay for any part of the offering which the stockholders may not want to take. The existence of such a syndicate and the resulting guarantee of the success of the offering has a strong moral effect upon the stockholders in encouraging them to subscribe, and an equally strong effect in discouraging speculators from short selling, while an unprotected offering presents a target to short selling.

The result is that a railroad can safely afford to offer securities at a much higher price when underwritten than they would risk fixing when not secured and protected by an underwriting.

After taking into consideration the expense of an underwriting syndicate, a railroad will usually obtain materially higher net proceeds from an underwritten offering, than from one not underwritten, in addition to the advantage of being certain of securing the required funds.

It is manifestly more advantageous to a railroad's financial position and the maintenance of the price level of its securities to offer a security, even to its stockholders, at say 110, and pay a reasonable underwriting commission rather than to offer it at par without an underwriting.

8. *The considerations which influence a railroad company to deal with a particular banking house are the same as those which influence similar relationships in other lines of business, as, for illustration, between the great cotton and woolen mills and the commission merchants through whom their products are marketed.*

The relations between the railroads and their bankers are very analogous to the relations between the great cotton and woolen mills and the commission merchants through whom their products are marketed. A mill lacking the organization or capital to market its own output usually establishes relations with some particular commission house with the necessary standing, selling organization and resources to enable it to insure a reasonably steady market for the mill's product and to supply it with funds when required.

No one would seriously argue that the mill would be better off if, instead of dealing with one particular commission house, it remained free from any such affiliation and depended upon its ability to sell the products of each season, either directly to the trade or to the commission house offering the most favorable prices and terms in competition. Such a policy would be so certain to bring loss and eventually failure that it would not even be considered.

The mill needs the co-operation of its commission merchant, who not only furnishes special experience and skill in marketing the mill's products, but insures capital when capital is needed to enable the mill to accumulate stocks and keep in operation during dull times. The fact that a mill deals exclusively with one commission merchant for a period of years does not place it at the mercy of that commission merchant, for the reason that competition regulates the prices at which the mill's products are sold by the commission merchant to the trade, and likewise, competition and custom regulate the profit or commission earned by the commission merchant.

A commission merchant who charges exorbitant commissions or profits for his services would soon lose his trade.

It is a matter of common knowledge that, while many mills have sufficiently large products and resources to enable them to maintain their own selling organizations, it has been found that, in the long run, the mill is better off if its products are handled by a commission merchant with his highly organized facilities.

All this is true of the relations between a railroad company and its banker, except that, unlike the mill with its products, the railroad is not in a position to market its securities directly to any advantage whatever, except possibly to the extent that, in special cases, it is able to sell securities to its own stockholders.

For that reason, the railroad in marketing its securities is even more dependent upon the banker than is the mill upon the commission merchant in selling its products, because, as already pointed out, the selling of securities is a much more complex operation than the sale of ordinary commodities.

To market railroad securities on a large scale requires a combination of skill, experience, capital, reputation and connections, both in this country and Europe, that, from the nature of the case, can be possessed by only a limited number of concerns at any one time, because most of these necessary qualities only the test of time will produce.

Just as custom and competition and reason regulate the profits of the commission merchant in handling the products of a cotton or woolen mill, so they regulate the profits of a banking house in handling the securities of a railroad company.

9. *The complexity of the business of marketing securities.*

The great complexity involved in the sale of securities will readily be seen from a brief outline of the method usually adopted in marketing a large issue of bonds. The

railroad, in the first instance, sells the issue to a strong banking firm. That firm then associates with itself a syndicate consisting of many (sometimes hundreds) of other banking, brokerage and investment houses in this country and Europe.

Pending the formation of such syndicate, the firm which has contracted with the railroad stands in the breach, and is responsible to the railroad whether or not it succeeds in forming the syndicate. Many of these participants have sub-participants who are sometimes investors and sometimes simply distributors.

Thus, begins the laborious process of selling securities to ultimate investors, through advertising, letters and circulars and personal presentation, and in this labor are usually engaged large numbers of dealers in securities, each with his own clientele. In time, if the issue is a success, the securities are absorbed.*

If not, the participants in the syndicate must either sell at a loss or carry them along until the advent of propitious times enables them to dispose of them; and of late years the necessity of such prolonged carrying has been the rule,

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*Within the past three years, i.e., since 1918, a certain change has taken place in respect to the processes of selling securities:

The operation of the income tax has not only cut down the total of surplus funds available for investment in the hands of the well-to-do, but has, to a very large extent, eliminated the large individual investor as a purchaser of ordinary bonds, because he can do far better by buying tax-exempt bonds which are obtainable on a basis averaging about 5½% (such a basis being equivalent to a yield ranging up to 20% on a taxable bond, according to the size of the income of the holder).

In consequence of this, and for other reasons, the placing of bonds must now be effected to a far greater extent than formerly, in relatively moderate sized lots. That means that the work of distribution has become much more laborious, difficult, and costly than formerly and requires the services of a small army of salesmen.

The spread between the purchase price and the selling price of a security must take care not only of the compensation of the managing bankers and the underwriters or the syndicate participants in return for their skill, services, responsibility, and risk, but also of the commissions to be paid to distributing retail houses throughout the country. Unless these latter commissions are sufficiently attractive and commensurate with the greater effort and cost required nowadays, the distributors simply will not make adequate efforts, inasmuch as they can always obtain very liberal commissions for placing foreign government bonds or industrial bonds, of which there is a particularly continuous supply offering at this time.

rather than the exception, and losses to syndicates and bankers have been frequent and heavy.

In this connection, it must be borne in mind that bankers do not buy securities for permanent investment by themselves. If the bankers permanently kept the securities which they bought from the railroads their capacity to buy securities would soon be exhausted. If securities are to be placed, they must ultimately find lodgment with investors, and, while the amounts of securities taken by large investors, such as the life insurance companies, savings banks and very rich men, seem to be large, their aggregate is small compared with the investments of the rank and file of smaller investors.

10. *The Lesson of Experience.*

It is a significant fact that practically all of the railroads which have gone into receivers' hands in recent years had followed the practice of selling their securities to different bankers at different times, and for the financing of such railroads, accordingly, no single banking house felt itself responsible.*

Frequently also the difficulty was that a defective financial system, making no adequate provision for the future, had been built up without the advice of skilled bankers. On the other hand, almost every *successful* railroad system in this country, as in Europe, has made it a practice, not only to arrange with bankers for the sale or underwriting of its securities, but to deal with some particular banking house of recognized strength and standing and European connections, and to deal principally with that banking house unless, for some reason, it chooses to change its bankers.

This has been true, not only of the railroad companies which through reorganization or otherwise have come to be

*(Examples: Wabash, Western Maryland, Wheeling & Lake Erie, Kansas City, Mexico & Orient, St. Louis & San Francisco, Norfolk & Southern, Chicago Great Western, etc.).

closely identified with some one banking house, but also of those whose management or control is entirely independent of any banking house or group of bankers, and which can have no possible inducement for habitually dealing with a particular banking house except the conviction that their best interests are served by doing so.

CONCLUSION

To compel railroads to have recourse for the sale of their securities to competitive bidding on the part of bankers and brokers, or to direct offerings to the public, would be to run counter to the practice and experience of every country in the world. It would confuse and trouble the investing public and destroy elements and features of evident and proved value for its protection, in that it would make the possession of capital the sole requisite for dealing in securities, irrespective of skill, care, reputation and the confidence of investors. It would limit, hamper and restrain the flow of capital (both of home capital and still more of European capital) into American securities and cause delay, uncertainty, damage and serious risk to American corporations. Railroads and other corporations should be left free, under the responsibility of their Boards of Directors, to deal with whatever banking houses they deem it in their best interest to employ. They should neither be bound by contract or control to deal with any one banking house exclusively, nor forced by statute or regulation to take the chances of competitive bidding or of direct dealing with the public.

Examples

The following are a few illustrative instances of railroad companies benefiting from the relations which exist between them and their bankers:

(*a*) In March, 1903, the Pennsylvania Railroad offered to its stockholders $75,000,000 of stock at 120 per cent., the market price at the time being about 145 per cent. Owing to the large difference between the market price and the

price of the offer, the railroad deemed it unnecessary to have the issue underwritten. Gradually, as stockholders sold their rights, a decline set in which reached such proportions that in May the market price had come down to 125½ per cent., and the failure of the railroad's offering appeared imminent. To avoid this and its resulting grave consequences, the railroad finally requested its bankers to form a syndicate to underwrite the issue, which was done. The reassuring effect upon the stockholders of the mere public announcement that a syndicate had guaranteed to take and pay for any part of the offering which was not subscribed for by the stockholders, was such as to arrest immediately the selling on the part of alarmed stockholders as well as speculative short selling, and to stop the decline in the market, and to turn a threatened failure into an entire success.

(*b*) The experience of the City of New York with its public offerings of bonds is illustrative. In at least one instance in recent years the city was compelled, in order to avoid total failure of a large issue to meet its pressing requirements, to have recourse to one of the leading banking houses, and in many instances of late it was only large subscriptions by such banking houses—made often without any expectation of profit, and resulting frequently in losses—which avoided the, at least partial, failure of the public offerings of the bonds of the City of New York.

(*c*) In September, 1905, The Erie Railroad arranged with its bankers to form a syndicate to underwrite the offer to its shareholders at 100 per cent. of $12,000,000. Convertible 4 per cent. Bonds, Series "B," (convertible into common stock at $60 per share). The result of the offering was that the stockholders subscribed for only 18 per cent. and, consequently, the syndicate had to take and pay for $9,840,000 of the bonds. The syndicate was dissolved in December, 1906, none of the bonds taken by it having been disposed of. The bonds were listed on the Exchange in February, 1907, when they sold at 85.

(*d*) In March, 1905, the Pennsylvania Railroad ar-

ranged with bankers to form a syndicate to underwrite the offer to its shareholders at par of $100,000,000 Pennsylvania Railroad 3½ per cent. Convertible Bonds (convertible into stock at 150 per cent.). The result of the offering was that the stockholders subscribed for less than 10 per cent. and that, consequently, the underwriting syndicate had to take and pay for about $90,000,000 of the bonds. The bonds within the year declined to 97½ per cent. and never again reached par, the price at which they were first offered. If it had not been for the underwriting syndicate, the situation resulting from the failure of the stockholders to subscribe and thus provide the money needed by the railroad, would have been very embarrassing to the railroad and very serious in its effect upon the general financial and investment situation of the country.

(*e*) In January, 1906, The Missouri, Kansas & Texas Railway arranged with its bankers to form a syndicate to underwrite the offer to its shareholders at 87½ per cent. of $10,000,000 General Mortgage 4½ per cent. Bonds. The result of the offering was that the stockholders subscribed for only 50 per cent. and the syndicate had to take 5,000,000 of the bonds. The syndicate was dissolved in December, 1907, only a few of the bonds taken by it having been disposed of.

(*f*) In 1904 the interests in control of the "Gould System," made up of the Missouri Pacific, Iron Mountain, Denver & Rio Grande and Rio Grande Western lines, deemed it important, in their competition with the Union Pacific and other transcontinental systems, to create an outlet to the Pacific Coast by building the Western Pacific Line from Salt Lake City to San Francisco. The companies in the Gould System were not strong enough to secure the money for the construction of this line, either by the sale of securities to their own stockholders or otherwise. They accordingly called in a syndicate of bankers, who, after months of study and negotiation, worked out a plan for the creation of an issue of $50,000,000 of bonds of the Western

Pacific Company guaranteed by the Denver & Rio Grande Company, which bonds were purchased by a syndicate formed by these bankers. After the Western Pacific Line was partially completed, it was found that the proceeds of the $50,000,000 bond issue were insufficient to complete and equip the line, and the bankers who placed the original issue of bonds advised the creation of an issue of refunding mortgage bonds and purchased $15,000,000 of 3-5 year notes secured by bonds of that issue. At a later date, viz., in 1912, when the refunding bonds had been exhausted and still further money were required, the same bankers advised the creation of Adjustment Seven Per Cent. Bonds of the Denver & Rio Grande Railroad Company and formed a syndicate to underwrite $10,000,000 of these bonds which were offered to the shareholders. The result was that the shareholders subscribed for practically none of the bonds, and the syndicate consequently had to take and pay for almost the entire issue, the bulk of which it still holds, the market price of the bonds having meanwhile declined 25 per cent. below the price at which the syndicate acquired them.

It is highly probable that if the law had required the public offering of securities or even if the Gould System had not been free to deal preferentially with some particular banking group, the original $50,000,000 of bonds for the construction of the Western Pacific Line could not have been placed. It is certain that the system would not have been able to meet the emergencies on the two subsequent occasions when it was found that large additional sums were required to carry the enterprise to completion. It was the support of the bankers who were identified with the orgiinal $50,000,000 bond issue and therefore morally committed to its support that carried the enterprise through. It should be added that, after the purchase by the bankers, each of the three issues declined in market value. Indeed, the decline in market value of the $50,000,-000 of bonds originally issued was so substantial that it

would have been impossible for the railroad companies to market additional securities by an offering to the public, or to stockholders, or in any other manner that did not involve the strong support of bankers who had a direct interest in supporting the enterprise.

(*g*) In May, 1907, the Union Pacific arranged with its bankers to form a syndicate to underwrite the offer to its stockholders at 90 per cent. of $75,000,000 4 per cent. Convertible Bonds (convertible into stock at 175 per cent.). The result of the offering was that the stockholders subscribed for barely 5 per cent., and that, consequently, the syndicate had to take and pay for about $70,000,000 of the bonds. The bonds in the course of the following six months declined to 78¼ per cent.

(*h*) In January, 1913, the Baltimore & Ohio Railroad Company arranged with its bankers to form a syndicate to underwrite the offer to its stockholders at 95½ per cent. of $63,000,000 4½ per cent. Convertible Bonds (convertible at 110 per cent.). The result of the offering was that the stockholders subscribed for barely 30 per cent. and, consequently, the syndicate had to take and pay for about $44,000,000 of the bonds. In the course of a few months the bonds declined to 88½ per cent.

(*i*) In April, 1906, the Wisconsin Central Railway arranged with bankers to form a syndicate to underwrite the offer to its shareholders at 89 per cent. and interest, of $7,000,000 Superior & Duluth Division & Terminal First Mortgage 4 per cent. Bonds. The result of the offering was that the stockholders subscribed for only 1 per cent. and the syndicate had to take $6,930,000 of the bonds. The syndicate expired by limitation July 1, 1908, none of the bonds taken by it having been disposed of in the interval.

(*j*) In March, 1910, The Atchison, Topeka & Santa Fe Railway Company arranged with its bankers to form a syndicate to underwrite the offer to its shareholders at 102½ per cent. of $43,686,000 Convertible 4 per cent. Bonds due 1960. The result of the offering was that the stockholders

subscribed for only about 12½ per cent., leaving about $38,226,000 of the bonds to be taken by the syndicate.

(*k*) In June, 1906, when the investment market in this country was practically at a standstill, American bankers placed an issue of Francs 250,000,000 Pennsylvania Company 3¾ per cent. Bonds in France; in February, 1907, an issue of Francs 145,000,000 New York, New Haven & Hartford Railroad Company 4 per cent. Bonds in France and Germany; in March, 1910, an issue of Francs 150,000,000 Chicago, Milwaukee & St. Paul 4 per cent. Bonds in France and England; and in February, 1911, an issue of Francs 250,000,000 Central Pacific Railway Company 4 per cent. Bonds in France and England. All of these loans were negotiated at times when it was of great advantage to the railroads as well as to the general financial situation to obtain money abroad. They took many weeks of preliminary negotiation and could not possibly have been negotiated on a competitive basis.

(*l*) In January, 1909, the Western Maryland Railroad sold to bankers $6,500,000 First Mortgage 4 per cent. Bonds. On January 18, 1909, about 90 per cent. of the bonds had to be taken up by syndicate participants. No bonds were disposed of by the syndicate until September, 1910, and from then on, at various dates up to February 28, 1911; thus, the syndicate lasted more than two years.

(*m*) In 1908, a situation had arisen which had brought the market for railroad bonds in this country to a complete standstill. Railroads for many months were unable to obtain funds, except to a limited extent, by means of the costly and dangerous expedient of selling short term notes. The effect was cumulative and far-reaching and threatened to bring about serious consequences. At this juncture the bankers of the Pennsylvania Railroad succeeded in inducing the two foremost banking houses in England, Messrs. N. M. Rothschild & Sons, and Messrs. Baring Brothers & Co., Ltd., (the former of whom had not issued an American security for many years) to purchase and bring out jointly

with them at 96 per cent. an issue of $40,000,000 Pennsylvania Railroad 4 per cent. Consolidated Bonds. Largely in consequence of the prestige and placing power and investment following of the issuing houses, the public offering was a complete success and its effect, as recognized by many published comments here and abroad, was to break the deadlock which had existed, and to cause capital to flow again freely into the investment market.

(*n*) In June, 1909, the Seaboard Air Line arranged with bankers for the formation of a syndicate to guarantee the sale of $18,000,000 Adjustment Bonds at 70 per cent. November 1, 1909, syndicate members took up about 90 per cent. of the bonds, which were disposed of in small lots between February, 1910, and November 30, 1910, the syndicate thus lasting about one and one-half years.

(*o*) In August, 1913, bankers formed a syndicate to underwrite the offer to Union Pacific stockholders of $88,000,000 Southern Pacific Stock Trust Certificates at 92 per cent. The effectuation of that sale was of very great importance as, failing it by a certain very near date, the Southern Pacific stock in question would have been placed, under the Court's decree, into the hands of a Receiver, the sentimental and actual effect of which course would have been grave. In the face of many predictions that a syndicate to guarantee the sale of so vast an amount of stock could not be formed under the then prevailing generally disturbed and unfavorable conditions, the bankers, with the aid of their connections throughout America and Europe, succeeded in the undertaking, the syndicate as finally made up consisting of nearly a thousand participants. It is entirely safe and well within bounds to say that if that mass of stock had been offered without guarantee and protection of an underwriting syndicate, it would not have been sold—if at all, within the time limit set by the Court—at a price averaging better than *80 per cent.*

(*p*) In connection with the first plan for the dissolution of the Union Pacific-Southern Pacific combination ap-

proved by Attorney General Wickersham (which failed of adoption because of the refusal of the California Railroad Commission to approve certain of its features) he *imposed* the condition that the sale of the Union Pacific Company's holdings of Southern Pacific stock, which would be offered for *pro rata* purchase to the stockholders in the Southern Pacific Company, should be underwritten by a syndicate. He imposed this condition for the manifest reason that the sale of the stock, however attractive the price to the stockholders might be, could only be insured in case definite arrangements were made for a sale of the stock that might not be taken by the stockholders upon the offering.

(*q*) In January, 1910, bankers purchased $22,000,000 Chicago City & Connecting Railways Collateral Trust 5 per cent. Bonds, and formed a syndicate at 91 per cent. The Syndicate expired in February, 1912, leaving syndicate members with almost 90 per cent. of the total amount unsold in their hands.

(*r*) To quote only one instance, typical of a great many, of syndicate operations in Europe: A loan for $20,000,000 Bonds of the Dominion of Canada was recently issued in London. The public subscribed to but $3,400,000, the balance, *i. e.,* $16,600,000 or 83 per cent. of the total loan, being left on the hands of the underwriting syndicate. It may safely be stated that a majority of the underwriting or purchasing syndicates formed in Europe during the last 18 months have resulted in syndicate members being compelled to take a large proportion of the securities purchased or underwritten, which they must either carry along for an indefinite period of time or sell as best they can.

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